Contracting for Transition
Contracts and Property Rights in Countries in Transition

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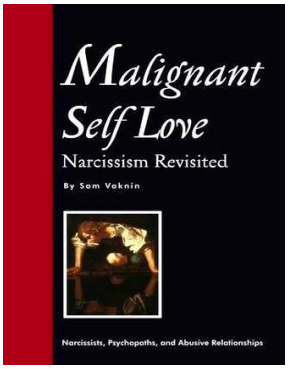

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The Kazakh minister of foreign affairs denied vehemently that Kazakhstan would revise contracts it has signed with foreign investors in the heady days of the early 1990's. It was in a meeting on March 26, 2002 with a delegation of nervous businessmen from the USA and it was expected and prudent - if not entirely truthful - of him to say so. He was merely echoing his autocratic president, Nazarbaev, who made the same promises to visiting and anxious State Department officials earlier that month.

Yet, the revision of dubious privatization contracts is now in vogue from Nigeria to the Czech Republic. It is even encouraged - though stealthily - by the new crusaders against corruption, the recently converted IMF and World Bank. This is surprising because these two also champion the protection of property rights and investments. An often politically-motivated revision of past deals is hardly the way to inspire confidence in jumpy foreign investors. The Kazakh minister summed it up neatly: "It (revision) would ruin the investment climate."

The Macedonians are less squeamish. The Macedonian Agency of Privatization has officially announced three years ago the review of 90 privatization deals concluded in more penumbral days. Of the first 9 firms reviewed, concluded the agency grimly, four were heavily tinted with irregularities. These consisted of partial disclosure of assets, leveraging of state-owned property, and reneging on obligations undertaken by the new owners to invest in the privatized firms.

In the wake of the heavily politicized campaign against the now-dismantled oil giant, Yukos, President Vladimir Putin of Russia changed the period for revision of venal privatizations from ten to three years. Still, hundreds of suspect deals under review with the aim of curbing the waning influence of the once almighty oligarchs.

There is no doubt that cronies, family relatives, strongmen, and members of the communist nomenklatura benefited mightily from the injudicious rash of ill-thought privatizations that swept through eastern and central Europe in the wake of the implosion of communism.

Mark Palmer, who served as US ambassador to Hungary in the 1980's, had this to say to RFE/RL:

"When communism was ousted in the late [19]80s, I do not think you had a total change. And these countries have all had to build more or less from scratch a culture of respect for the law, judges that are politically independent, lawyers that are knowledgeable, businessmen who recognize the importance of contracts. All of this has had to be developed, and it's not surprising that it's taking quite a while."

Yet, many question the wisdom of re-opening this particular can of worms. Most of the privatized firms changed owners, or were floated in stock exchanges, merged, or completely transformed themselves. Raising ownership issues in this belated manner may adversely affect significant segments of the tottering economies of the post-communist countries in transition.

The distrust between citizen and state in these countries - already all-pervasive - will only grow if the latter took to arbitrarily and retroactively abrogating contracts they have signed. Few would believe that such "reviews" are not politically motivated. Most would surmise that it is the current regime's way of getting back at its predecessors and re-distributing stolen wealth.

But perhaps a more imminent and long-term danger is the further undermining of the concept of "commercial contract" - a novelty in these nether regions.

In the early period of transition, contracting was debased by the absence of functioning and impartial judicial and law enforcement institutions. Private enforcement of oft-informal contractual obligations by organized crime or corrupt officials was a growth industry - and not only in derelicts like Russia, Ukraine, Belarus, Moldova, Albania, Bulgaria, or Serbia-Montenegro. It was rife even in paragons of EU rectitude such as Hungary, or in the less exalted Czech Republic.

The situation was so bad that Russian managers collaborated only with commercial partners they knew from the days of central planning (Kathryn Hendley and others, 1997, "Observations on the Use of Law by Russian Enterprises," published in Post-Soviet Affairs, Vol. 13).

This made it impossible for newcomers and foreign competitors to break into the market. Long-terms investment and research and development were stymied - as were transfers of technology and know-how. Transaction costs soared.

The emergence of an entrepreneurial middle class changed all that. Contract law is now enforced in courts rather than without. In October 1999, in a position paper prepared for the "Partners in Transition, Lessons for the Next Decade" conference in Warsaw, the IRIS Centre in the University of Maryland felt comfortable to state:

"Significant progress towards an effective rule of law has been made since that period in many of the transition countries. For example, a recent survey of firms in Russia found that both the law and courts were important elements in resolving disputes between firms and promoting the enforcement of contracts."

The evidence is far from decisive though.

Numerous studies (by Hendrix and Pei, by Hendley, Murrell, and Ryterman in their 1998 survey of Russian managers, by Berkowitz, and others) demonstrated that Russian courts were capable of handling contract dispute resolution reasonably adequately. Efforts invested by firms in constructing contracts and in obtaining legal knowledge - pays handsomely even in Russia.

Other scholars (Rose, 1999 and Kaariainen and Furman, 2000, to mention recent ones) report that foreign businessmen complain about a low respect of the law, contradictory legal rulings, and frequent breaches of contract (reported in "Russian Enterprises and Company Law in Transition" by S. Nysten-Haarala and published by the International Institute for Applied Systems Analysis in Austria).

IRIS has identified five key elements critical to the proper functioning of contract law in the transition countries:

1. The law must be a neutral, principled, and unbiased arbiter of disputes;
2. The role of the omnipotent procurator (state prosecutor) must be re-defined;
3. New civil legislation must be consistent, efficiently communicated to the public, and backed by credible policies;
4. Assuring the effectiveness of the enforcement of judgments is critical;
5. Increasing respect for the rule of law by hiring professional, honest, impartial, and capable judges and law enforcers - or by training and educating them to be so.

But how important are enforceable contracts and property rights to start with?

IRIS succinctly concludes:

"Institutions that define and enforce contracts, make possible the use of collateral in borrowing, provide a legal basis for complex long-term transactions, define and ensure property rights, and above all, prescribe and enforce social order, have been shown in a number of IRIS studies to be closely correlated with economic growth."

Cheryl Gray from the World Bank wrote in "Reforming Legal Systems in Developing and Transition Countries":

"If a dense and efficient network of commercial relationships is to flourish in an economy, it needs a credible and low-cost formal legal process to which aggrieved parties can turn when all else fails."

In their article "Contract-Intensive Money: Contract Enforcement, Property Rights, and Economic Performance", published in Journal of Economic Growth, 1999 - the late Mancur Olson, together with other luminaries (Christopher Clague, Phillip Keefer, Steve Knack), developed the CIM (Contract Intensive Money) index. It is the part of M2 which is not comprised of currency outside banks.

They demonstrated that even "self-enforcing" trades are sensitive to government policies, especially to contract enforceability and property rights. Thus, CIM is high (i.e., people hold cash) where third-party legal enforcement of contracts is unreliable. This is the case in all countries in transition.

In another seminal paper ("Property and Contract Rights in Autocracies and Democracies" in American Journal of Political Science, 1997), the same authors correlated the age of democratic systems with the extent of property rights and dependence on contracts. The younger the democracy, the less these are entrenched. This is because young democracies - such as the countries in transition - have shorter planning horizons. Their interest in future tax collection and national income is limited.

Keefer and Knack proved convincingly (in "Institutions and Economic Performance", Economics and Politics, 1995) that good governance and property

rights (or the lack thereof) significantly affect economic growth - and, by implication, poverty reduction. A 1999 study (by Sala-i-Martin) ran 4 million regressions to incontrovertibly confirm the robustness of the indices used by Keefer and Knack.

Blanchard and Kremer ("Disorganization" in Quarterly Journal of Economics Vol. 112, November 1997) went as far as claiming that the absence of contract enforcement mechanisms is sufficient to explain the disastrous contraction in the output of the post-communist countries.

But this may be going way too far.

Johnson, McMillan, and Woodruff studied five transition economies ("Contract Enforcement in Transition" CEPR Discussion Paper 2081, 1999). They discovered that most firms engaged in "relational contracting" and relied on this informal network of relationships - rather than on the courts - to efficiently and expediently resolve commercial disputes.

Hendley, Murrell, and Ryterman ("Law, Relationships, and Private Enforcement", 1999) describe seven strategies used by Russian enterprises in pursuing efficiency and predictability in business relationships, among them self-enforcement, administrative levers of law, and shadows of law (raising the specter of a lawsuit).

Moreover, it would be wrong to lump all the countries in transition together.

Huge disparities among these countries are evident in a series of annual surveys carried out between 1995-8 by the Central European Economic Review, the EBRD, and BEEPS (World Business Environment and Enterprise Performance Survey). "Rule of Law" ratings ranged from 8.7 (Poland) to 2.7 (Albania and Uzbekistan). "Legal Effectiveness" ratings (from 1 to 4) stretched from 1 (Bosnia) to 4 (Czech Republic, Estonia, Macedonia). And "Enforcement" straddled the divide between 0.26 (Ukraine and Moldova) and 0.77 (Estonia).

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